DEPARTMENT OF STATE REVENUE

01-20182350R.SODR

Supplemental Final Order Denying Refund: 01-20182350R
Indiana Individual Income Tax
For the Years 2012, 2013, 2014, and 2015

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Final Order Denying Refund.

HOLDING

Indiana Residents were not entitled to claim a "credit" on their individual Indiana income tax returns for taxes paid by their business to out-of-state municipal governments because Indiana law contained no provision allowing the credit to "flow-through" from the business to the Indiana Residents.

ISSUE

I. Individual Income Tax - Credit for Taxes Paid in Another State.

Authority: IC § 6-3-3-10(h); IC § 6-3.1-4-7; IC § 6-3.5-1.1-6; KRS 91.260; Louisville, Kentucky Metro Code § 110.02(D); *INDOPCO, Inc. v. Comm'r.*, 503 U.S. 79 (1992); *Parker Pen Co. v. O'Day*, 234 F.2d 607 (7th Cir. 1956); *State v. Smith* 158 Ind. 543, 63 N.E. 25 (1902); *Florer v. Sheridan*, 137 Ind. 28, 36 N.E. 365 (1893); *Ind. Dep't of State Revenue v. Food Marketing Corp.*, 403 N.E.2d 1093 (Ind. Ct. App. 1980); Final Order Denying Refund 01-20180711 (September 25, 2018);

Taxpayers argue that they are entitled to a refund of Indiana income tax on the ground that they are entitled to claim an Indiana "credit" for local taxes paid in another jurisdiction.

STATEMENT OF FACTS

Taxpayers are husband and wife Indiana residents who filed joint Indiana individual income tax returns for 2012, 2013, 2014, and 2015. Husband is the owner of a Kentucky business. The business is organized as a Limited Liability Partnership ("LLP") which elected to be taxed as an S Corporation. That business paid three local taxes. The business paid local taxes to Louisville, Kentucky; Lexington, Kentucky; and Cincinnati, Ohio. The local Kentucky taxes are authorized under Kentucky law and the local Ohio tax is authorized under Ohio law.

Taxpayers filed a GA-110L ("Claim for Refund") seeking a refund of approximately $12,000 in Indiana income tax paid during 2012, 2013, 2014, and 2015. The refund was attributed to a claimed credit against Taxpayers' local Indiana income taxes for the taxes paid to Louisville, Lexington, and Cincinnati.

In a letter dated December 2017, the Indiana Department of Revenue ("Department") denied the refund explaining:

> Supporting documentation to disprove the referenced tax liabilities were not timely submitted.

Taxpayers disagreed with the Department's decision denying the refund and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representative explained the basis for the protest. Final Order Denying Refund 01-20180711 (September 25, 2018), 20181226 Ind. Reg. 045180526NRA ("ODR"), was issued denying the refund. As explained in the September ODR:

> In the present case, Taxpayers have not established that the tax at issue was imposed on the husband personally and not on the Limited Liability Partnership itself.

Taxpayers disagreed with the decision denying the refund and requested a rehearing. The rehearing was granted and this Supplemental Final Order Denying Refund results.

I. Individual Income Tax - Credit for Taxes Paid in Another State.

DISCUSSION

The issue is whether Taxpayers have established that, under Indiana law, they are entitled to claim a credit for taxes paid to other out-of-state jurisdictions against the amount Taxpayers paid to an Indiana local jurisdiction. The Department disagreed with Taxpayers' contention on the ground that there was insufficient information to allow the credit. Taxpayers disagreed as follows:

> [The Department] has erroneously imposed additional Income Tax against taxpayers inappropriately by denial of the credit taken on such returns for taxes paid to non-Indiana localities (Kentucky) due to the erroneous belief that "The Local credit only applies to 'income tax' paid to the other locality." [And that] "Occupational license tax is calculated based on the amount of income the business makes, but is not an income tax."

Taxpayers described what they believed was the relevant background.

> [Husband] is an owner of a business in Kentucky which pays local income based taxes on form OL-3 in [] County, Kentucky as well as other local jurisdictions. Such amounts paid represent income based taxes and should be allowed to be taken as credits on Taxpayers individual income tax returns as "Credits Paid to non-Indiana Localities." [The Department] denied these credits after reviewing the returns supporting the credits taken under the sole precept that the taxes paid are not "income based taxes."

Taxpayers necessarily rely on IC § 6-3.5-1.1-6 as their basis for claiming the Indiana credit:

> (a) Except as provided in subsection (b), if for a particular taxable year a county taxpayer *is liable for an income tax imposed by a county, city, town, or other local governmental entity located outside of Indiana, that county taxpayer is entitled to a credit against his county adjusted gross income tax liability for that same taxable year.* The amount of the credit equals the amount of tax imposed by the other governmental entity on income derived from sources outside Indiana and subject to the county adjusted gross income tax. However, the credit provided by this section may not reduce a county taxpayer's county adjusted gross income tax liability to an amount less than would have been owed if the income subject to taxation by the other governmental entity had been ignored.
>
> (b) The credit provided by this section does not apply to a county taxpayer to the extent that the other governmental entity provides for a credit to the taxpayer for the amount of county adjusted gross income taxes owed under this chapter.
>
> (c) *To claim the credit provided by this section, a county taxpayer must provide the department with satisfactory evidence that he is entitled to the credit.*

The Kentucky municipalities imposed their local taxes under authority of KRS 91.260 which provides in part:

> Each city of the first class shall raise a revenue from ad valorem taxes and from taxes based on income, licenses and franchises. The board of aldermen may each year, by ordinance, levy an ad valorem tax on all real and personal property subject to taxation for city purposes, at a rate within the limits prescribed in the Constitution, and may provide for taxation, for city purposes, on personal property based on income, licenses or franchises in lieu of an ad valorem tax thereon, but may not omit the imposition of an ad valorem tax on the taxable personal property of any steam, railroad, street railway, ferry, bridge, gas, water, heating, telephone, telegraph, electric light or electric power company, and may not levy or collect an income tax.

Louisville, Kentucky Metro Code § 110.02(D) provides in part:

> The occupational license taxes imposed in this chapter are assessed against business income at the entity level and before it is passed through to the partners, members, shareholders or owners.

The Department denied Taxpayers the credit on the ground that it was the business which paid the tax and that Taxpayers - subject to Indiana's individual income tax - were not entitled to claim an income tax credit on their individual returns. As noted above, the issue is whether the credit attributable to the taxes paid by the business "flows through" to the benefit of the business's owners.

In relevant contrast to IC § 6-3.5-1.1-6, the Indiana legislature has specifically provided for "credits" which "flow-through" to non-resident partners. For example, IC § 6-3.1-4-7, provides as follows:

(a) If a pass through entity does not have state income tax liability against which the research expense tax credit may be applied, a shareholder, partner, or member of the pass through entity is entitled to a research expense tax credit equal to:
(1) the research expense tax credit determined *for the pass through entity* for the taxable year; multiplied by
(2) the percentage of the pass through entity's distributive income to which the shareholder, partner, or member is entitled.
(b) The credit provided under subsection (a) is in addition to a research expense tax credit to which a *shareholder, partner, or member of a pass through entity is otherwise entitled under this chapter*. However, a pass through entity and a shareholder, partner, or member of the pass through entity may not claim a credit under this chapter for the same qualified research expenses.

(*Emphasis added*).

From this - and other examples - it is apparent that Indiana's legislature is totally capable of structuring an income tax credit such that the credit could "flow-through" to a "shareholder, partner, or member of the pass through . . . ." In the case of the credit provided for under IC § 6-3.5-1.1-6, the legislature made no such provision and Taxpayers are not entitled to "read into" the statute a provision which is otherwise entirely absent. *See also* IC § 6-3-3-10(h) (allows the "Enterprise Zone Credit" to "flow through" to a "shareholder, partner, beneficiary, or member . . . .").

A deduction such as that found in IC § 6-3.5-1.1-6 is not an exemption. See *State v. Smith* 158 Ind. 543, 63 N.E. 25 (1902); *Florer v. Sheridan*, 137 Ind. 28, 36 N.E. 365 (1893). However, the credit allowed for local taxes has the same result as an exemption and the taxpayer has the burden of establishing that it is entitled to that deduction. "The enlarged deduction has the same end result as the enlarged exemption. In both instances, the tax burden of the individual taxpayer is decreased; but in so doing, the tax burden of all other taxpayers is increased. The allowed or enlarged deduction shifts the tax burden. Thus, like the tax exemption, the tax deduction should be narrowly construed." *Ind. Dep't of State Revenue v. Food Marketing Corp.*, 403 N.E.2d 1093, 1102 (Ind. Ct. App. 1980) (Staton, J. dissenting). The principle that deductions are narrowly construed is well-founded in federal law. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *INDOPCO, Inc. v. Comm'r.*, 503 U.S. 79, 84 (1992). "[S]tatutes creating deductions are to be strictly construed against the taxpayer." *Parker Pen Co. v. O'Day*, 234 F.2d 607, 609 (7th Cir. 1956).

In this case, Taxpayers' business paid taxes to several local jurisdictions because the tax was imposed on the business. Under Indiana law, there is no provision allowing the business's owners to claim a local credit on their individual returns. Taxpayers' otherwise good-faith attempt to claim the credit is not permitted under Indiana law and flies in the face of the principle that deductions are "narrowly construed . . . ." *Food Marketing Corp.*, 403 N.E.2d at 1102. Taxpayers have not met their burden of "clearly showing [their] right to the claimed deduction . . . ." *INDOPCO, Inc.* 503 U.S. at 84.

FINDING

Taxpayers' protest is respectfully denied.

January 31, 2019

Posted: 03/27/2019 by Legislative Services Agency
An html version of this document.